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## **Committee on Balance-of-Payments Restrictions**

### **REPORT ON THE 1995 CONSULTATION WITH HUNGARY**

1. The WTO and the GATT 1947 Committees on Balance-of-Payments Restrictions consulted jointly with the Republic of Hungary on 26 and 30 June 1995. The consultations were held under the Chairmanship of Mr. P. Witt (Germany) and in accordance with the terms of reference, pursuant to Article XII:4(a) of GATT 1994 and the Understanding on the Balance-of-Payments Provisions of GATT 1994. The International Monetary Fund was invited to participate in the consultation in accordance with Article XV:2 of GATT 1994.

2. The Committees had the following documents before it:

Basic document supplied by the Republic of Hungary WT/BOP/2

Background paper by the Secretariat WT/BOP/W/4

Notification by Hungary under paragraph 9 of the Understanding on the Balance-of-Payments Provisions of GATT 1994 WT/BOP/N/2

International Monetary Fund Hungary, Recent Economic Developments and Background Issues dated 10 March 1995.

#### **Opening Statement by the Representative of Hungary**

3. The opening statement of the representative of Hungary is attached as Annex I.

#### **Statement made by the Representative of International Monetary Fund**

4. The Statement made by the representative of the International Monetary Fund is attached as Annex II.

#### **Discussion in the Committees**

(i) Balance-of-payments position and prospects; alternative measures to restore equilibrium

5. Members of the Committees welcomed that Hungary had recognized the need for structural measures to address the twin deficit problem of external imbalances and large budget deficit and encouraged Hungary to proceed with its economic reform. Members noted, however, that the package of stabilization measures announced in March 1995, although valuable, contained essentially short term corrective measures such as import surcharge and public sector real wage reductions. Members

hoped that Hungary would replace or supplement these by measures with lasting structural impact on the public sector finances and the balance-of-payments situation.

6. The representative of Hungary stated that imbalances in domestic savings and investment had contributed to the worsening of the current account situation. The stabilization program focused on measures to increase overall savings: decrease of domestic demand; increase of the profitability of enterprises through cuts in real wages; and creation of incentives to increase household savings through changes in the pension system. The import surcharge was considered a temporary solution. Meanwhile the authorities would explore ways of more permanent reduction in public expenditure through reform of the pension, health and education systems and cuts in various subsidies. Furthermore, the Government, with the co-operation of the National Bank, aimed to improve the structure of the budget deficit by further cuts in expenditures which would result in a 3 per cent reduction of the budget deficit/GDP ratio. The Hungarian authorities had chosen to introduce the import surcharge to improve the current account deficit rather than to face the inflationary effect of a larger devaluation of the forint. Hungary was a large importer of energy products and it was expected the exemption of such products from the coverage of the surcharge would help to prevent cost push inflation.

7. With regard to the restructuring of the external debt, the representative of Hungary stated that the share of short term debt in the total had been reduced from over 70 per cent to less than 20 per cent between 1990 and 1994 and the share of borrowing by the National Bank had fallen in favour of enterprise borrowing.

(ii) System, methods and effects of import restrictions

8. Members of the Committees expressed the view that the import surcharge was a price-based measure and, therefore, was preferable to other non-transparent measures. Nevertheless, they considered that import surcharges should be used to address balance-of-payments difficulties in exceptional circumstances and not as a panacea for dealing with a worsening fiscal situation. Import measures should be fully justified under the provisions of GATT and should only be maintained for a temporary period. Hungary was invited to provide a detailed time-table for the phasing out of the import surcharge.

9. In response, the representative of Hungary stated that while Hungary had had budget deficit over the past several years, the import surcharge was introduced only when Hungary was faced with the exceptionally difficult current balance-of-payments situation.

Conclusions

10. The Committees commended Hungary for the progress achieved in its transition to a market-based trade and economic system. They noted with satisfaction that, since 1989, Hungary had taken significant steps to liberalize its trade régime and to move towards the convertibility of the forint.

11. The Committees recognized that Hungary had experienced a deep recession with high inflation in the years 1991-1993. The growth rate of 2.6 per cent in 1994 was accompanied by a further serious decline in exports (on a balance-of-payments basis) and by a high level of imports. The savings-investment imbalance worsened considerably in 1993 and 1994. The Committees noted that both external factors and domestic policy failures had contributed to the deterioration of the current

account in the past two years. The deficit had been financed by capital inflows, allowing the reserve position to improve, but external indebtedness had further increased.

12. The Committees recognized that Hungary had introduced the import surcharge in March 1995 to address the imminent threat of a serious decline in its balance of payments. The surcharge formed part of an economic stabilization package aimed at correcting current account and fiscal imbalances. The package also included austerity measures to curb budgetary expenditures, a one-step devaluation of the forint and the introduction of a crawling peg exchange rate régime.

13. The Committees welcomed the fact that Hungary had notified the import surcharge to the WTO before its introduction. They recognized that the measure was price-based, uniform and non-discriminatory, that the surcharge applied to all imports except primary energy products, and that it was reimbursable on investment machinery.

14. The Committees noted Hungary's intention to reduce the import surcharge progressively, beginning not later than 1 January 1997, and to eliminate it by 1 July 1997. They endorsed the statement by the IMF stressing the importance of eliminating the surcharge within the intended schedule, or preferably sooner, and emphasized that import surcharges should not be used for fiscal purposes but only in the case of severe balance-of-payments difficulties. The Committees expressed their hope that, by the time of the next consultation, to be held in summer 1996, Hungary would be in a position to evaluate the effects of the surcharge on its balance of payments and to elaborate on its intention to replace the surcharge by permanent structural measures. The Committees requested Hungary also to present for the next consultation a concrete time-table for the reduction and elimination of the import surcharge.

## ANNEX I

### Opening Statement by the Representative of Hungary

1. The Hungarian Government wishes to present to members of this Committee and, through them, to other WTO Members the case of the temporary import surcharge that has been applied by Hungary since 20 March 1995 in order to forestall the imminent threat of a serious decline in its balance-of-payments position. In doing so, we act pursuant to the provisions of Article XII:4 of the General Agreement and in conformity with the relevant provisions of the 1979 Declaration on Trade measures taken for Balance-of-Payments Purposes and the Understanding of the Balance-of-Payments Provisions of the GATT 1994.
2. The surcharge was notified by Hungary before its introduction, as required by Article XII:4(a). Pursuant to the Decision of 31 January 1995 on avoidance of procedural and institutional duplication, this notification, contained in WTO document WT/BOP/N/2, dated 29 March 1995, is deemed to be also a notification for the purpose of Article XII of GATT of 1947. The Basic Document for this consultation provided by the Hungarian authorities is contained in WTO document WT/BOP/2, dated 6 June 1995.
3. The temporary surcharge, that has been introduced by Decree 9/1995 of 17 March, is applied on imports of goods. No measure has been taken under the Balance-of-Payments Provisions of Article XII of the General Agreement on Trade in Services.
4. Let me turn to the general context of, and particularly the specific circumstances that led to the temporary import surcharge. The profound and radical systemic changes that has taken place in Hungary in the late 80's and early 90's accelerated the economic reforms and redirected them to a transformation into a market, free-enterprise economy. One of the most important changes that resulted from these reforms was a significant deregulation in, and opening up of, the economy in general, and a fundamental liberalization of the foreign trade régime and market access in particular.
5. The process of opening to the world economy resulted in structural changes and shifting trade patterns which, coupled with the downfall of the CMEA-system and particularly the collapse of our most important former markets in Eastern Europe, led to a considerable reorientation of Hungary's trade relations. Trade with OECD countries expanded substantially to reach the share of about three fourths in total Hungarian trade, while trade with former CMEA countries, which had accounted for over one-half of Hungary's total trade has fallen to less than one quarter by 1994.
6. As to particular trade measures, Hungary significantly reduced or liberalized tariffs and non-tariff measures as a result of both autonomous actions or contractual obligations. Autonomous tariff reductions that had been introduced in recent years have reduced the average MFN duty level from 13 to less than 10 per cent. In the Uruguay Round Hungary committed itself to reduce its tariffs on industrial products by 28 per cent over the implementation period, by the end of which the average level will fall below 7 per cent.
7. Concerning non-tariff measure, the general licensing requirement that had prevailed until the late 1980's had been abolished and the scope of products subject to authorization considerably reduced since 1989. As a result of liberalization measures, non-tariff barriers applied in the form of import licensing and the global quota on consumer goods have been significantly relaxed or abolished in recent years. As part of the implementation of Hungary's Uruguay Round market access commitments, discretionary licensing for primary agricultural goods and the global quota restriction on food products

as well as that on underwear have been abolished on 1 January 1995. Products still falling under the global quota (passenger cars, textile and clothing products, footwear, household detergents) represent less than 5 per cent of total imports. At present about 8 per cent of imports are subject to licensing.

8. Hungary is also committed to further liberalization measures under bilateral or plurilateral free trade agreements that have been concluded with some of its European partners, namely the European Communities, the EFTA States, the countries parties to the Central-European Free Trade Agreement and Slovenia.

9. As a result of different liberalization measures, growing import demand as well as adverse external circumstances, Hungary's trade performance in the past two years showed unfavourable tendencies. The value of exports in 1994, after a steep fall in 1993 climbed back to the 1990 level of US\$10.7 billion. At the same period, responding to trade liberalization, strong internal demand and real appreciation of the Hungarian Forint, imports grew steadily from the 1992 level of US\$11 billion to US\$12.5 billion and US\$14.5 billion in 1993 and 1994, respectively. While by 1994 real GDP remained roughly at the level of 1992, real growth of imports increased over 20 per cent in the past two years.

10. The trade deficit that had been US\$356 million in 1992 increased tenfold in 1993 and further expanded to reach US\$3.9 billion in 1994. Trade imbalances with developed market economies accounted for about two thirds of the total deficit.

11. Deterioration of the trade balance constituted the single most important cause for the emergence of a serious current account deficit, reaching US\$3.9 billion and exceeded 9 per cent of the GDP in 1994.

12. The current account deficits had been financed to a large extent by official and enterprise borrowing, as a result of which the external debt increased. The ratio of net foreign debt to GDP reached 46 per cent last year. Growing imbalances in the current account and increased external indebtedness have been coupled by the deterioration of the budget deficit in recent years. The deficit in the consolidated state budget amounted to the level of over 6 per cent of the GDP in 1994.

13. Developments in early 1995 showed tendencies of further aggravation of the situation. In the first 4 months of the year the balance of trade showed a deficit of over US\$1.5 billion, and increase of 36 per cent of the same period last year. The current account deficit amounted to US\$1.420 million in the first quarter.

14. It was against this background that the Government of Hungary had to resort to measures addressing the situation characterized by an imminent threat of a serious decline in the balance-of-payments. On March 12, the Hungarian Government adopted a package of stabilization measures of which the temporary surcharge was one component.

15. The package that required amendments to 21 different laws, aims at restoring the macroeconomic balances by cutting domestic demand and improving the competitiveness of Hungarian production. For reducing the growth of domestic demand the package includes:

- (i) a significant cut in Government expenditures, particularly reducing social transfers as well as funds for institutions financed by the Government;

- (ii) measures to increase budgetary revenues by strengthening control over illegal economic activities and improving tax collection; and
- (iii) lowering the growth of wages in the budgetary sectors and in the state-owned companies which employ together more than half of the Hungarian working force. Due to the lower growth of wages in these sectors the wage growth in the private sector also substantially declined and the real wage level in the first quarter of the year has declined more than 8 per cent.

16. For improving the competitiveness of the Hungarian production the most important steps are the following:

- (i) a one time 9 per cent devaluation of the Forint, following further pre-announced crawling peg devaluation steps. As a result of this the real exchange rate of the Forint has improved substantially, especially on a unit labour cost basis. The pre-announced crawling peg has cut speculation and capital flight.
- (ii) further liberalization in the foreign exchange regulations, eliminating the surrendering obligation in the business sector, thus cutting the costs for those companies which have important export and import turnover.
- (iii) substantial increase of capital in the Hungarian Export Credit guarantee Agency and in the Hungarian Exim Bank.

17. As to the temporary surcharge, which amounts to 8 per cent, I would like to emphasise the following:

- (i) The Hungarian Government opted not to apply quantitative restrictions or discretionary licensing for balance-of-payments purposes. By choosing a price-based measures as one of the tools for addressing the serious trade imbalances, the Government honoured its commitment in the Understanding to give preference to a measure that has the least disruptive effect on trade.
- (ii) Furthermore, Hungary has not introduced more than one type of restrictive import measure, as is required in paragraph 3 of the Understanding.
- (iii) The surcharge is applied only to exercise control on the general level of imports. One of its most essential features is that it is not providing relief or protection to any specific industry. It is applied across the board, the only products excluded from its scope being primary energy carriers, while in the case of complete machines and auxiliary machines falling under Chapters 84 and 85 of the Harmonized System that are imported for investment purposes, the surcharge is reimbursable. The exclusion from the scope of application or the reimbursement of the surcharge for these products is necessitated by their essential nature in the sense of paragraph 4 of the Understanding, i.e. these are products that meet basic consumption needs and contribute to Hungary's efforts to improve its balance-of-payments situation.
- (iv) Another fundamental characteristic of the surcharge is its uniform and non-discriminatory application. It is levied on an erga omnes basis on imports from all sources, irrespective of whether or not Hungary's trade relations with a given country are based on Article XXIV of GATT.
- (v) The Surcharge is calculated on the basis of the customs value of the imported products.



(vi) Furthermore, the level of the surcharge does not exceed what was strictly necessary to address the balance-of-payments situation. The short period since the introduction does not permit the assessment of the trade effects of the surcharge, but it may hopefully slow down the dynamics of the prevailing strong import growth.

18. Based on the above features, my Government considers that the import surcharge is in full compliance with the requirements in Article XII of GATT, the Declaration on Trade Measures taken for Balance-of-Payments Purposes and the Understanding on Balance-of-Payments Provision of GATT 1994.

19. Hungary recognizes the exceptional nature of trade restrictions taken for balance-of-payments purposes and wishes to fully adhere to the commitments in this area resulting from the Uruguay Round.

20. In this context, I wish to announce that, pursuant to paragraph 1 of the Understanding, the Hungarian Government intends to reduce progressively and eliminate the temporary import surcharge by 1 July 1997 unless developments in the balance-of-payments situation does not require otherwise.

21. I would also like to reconfirm my Government's commitment to continue to pursue liberal and open trade policies.

22. The Hungarian delegation is ready to respond, to the best of its abilities, to any questions and comments from members of the Committees. We count on your understanding and friendly partnership.

## ANNEX 2

### Statement by the IMF Representative at the 1995 Consultation with Hungary

In March 1995, the Hungarian Government adopted a substantial policy adjustment package that included among other measures the imposition of an 8 percent import surcharge. The package came in response to a large and rising external deficit and an incipient widening of the fiscal deficit.

The rebound in domestic demand in 1993/94, coupled with an inadequate domestic supply response, was reflected in a sharp deterioration in the balance of payments. Exports were hampered partly by exogenous factors—including the recession in Western Europe through 1993, the U.N. embargo on the Former Republic of Yugoslavia (Serbia/Montenegro), and drought conditions with a negative impact on agricultural exports. However, earlier losses in cost competitiveness and the slow progress in many areas of structural reform in recent years also limited the domestic supply response. These developments also contributed to the strong increase in imports. Moreover, consumer goods imports were boosted by a decline in the household saving rate in 1993 and by rapidly rising real wages in 1994. Under these circumstances, the external current account deficit increased to close to 10 percent of GDP in 1993 and remained at that level in 1994. While foreign direct investment inflows continued at historical levels, the larger part of the deficit was financed by borrowing by the National Bank of Hungary and the enterprise sector in international capital markets. As a consequence, net external debt increased to US\$19 billion (46 percent of GDP) at end-1994 and the debt-service ratio reached about 53 percent of exports—a high level in international comparisons.

Fiscal policy continued to be too expansionary in 1994. Even though fiscal revenues benefitted from the resumption of economic growth—GDP increased by some 2 percent—the deficit of the consolidated state sector (excluding privatization receipts) declined only marginally to 6.9 percent of GDP in 1994 from 7.5 percent in the previous year. Monetary policy was tightened significantly during 1994; this continued during the first part of 1995 as official interest rates were raised and reserve requirements were increased in several steps. However, inflation began to accelerate after the first quarter of 1994 and was boosted in early 1995 by sharp increases in energy prices and rising food prices; subsequently, price increases were affected by the impact from the policy package of March 1995. As a result, the year-on-year increase of consumer prices accelerated to above 29 percent in April 1995 from a low of 16.5 percent in early 1994.

Available indicators suggest that the broad macroeconomic trends of 1994 continued in early 1995. The external current account deficit was US\$1.4 billion in the first quarter, adding further to external indebtedness. In flow terms, foreign exchange reserves fell by US\$1 billion even though the stock at end-March still stood at US\$6.8 billion, a result of favorable movements in cross exchange rates.

Against this background, and signs of a widening fiscal deficit in early 1995, the authorities adopted an adjustment package in mid-March that is now being implemented. It comprised three principal components: a set of fiscal measures, including reforms to some social programs, designed to hold the budget deficit (excluding privatization) to about 6 percent of GDP in 1995; a step devaluation of the forint followed by a switch to a pre-announced crawling peg exchange rate; and policies designed to substantially lower the real wage bill in the government sector and the state enterprises. The package is geared at achieving a reduction in the external current account deficit to US\$2.5 billion in 1995 from



US\$3.9 billion in 1994. With sizable privatization receipts expected from foreign sources as well as continuing other regular foreign direct investment, the authorities estimate that a current account deficit of this size could be financed almost in full without an increase in net external debt.

A key element of the measures adopted in March was an 8 percent import surcharge effective March 20, 1995. By increasing the relative price of imports, it is expected to have a direct positive effect on the balance of payments. The surcharge is estimated to raise budget revenues by about 1 percent in 1995. As it would have been preferable to lower the fiscal deficit through other means, Executive Directors of the IMF, at the time of the Article IV consultation in March 1995, regretted the introduction of the import surcharge, and they stressed the importance of its elimination by mid-1997 according to the intended schedule, and preferably sooner.

To switch resources to the external sector and cushion the output effects of the fiscal adjustment, the exchange rate of the forint was devalued by 8.3 percent effective March 13. At the same time, a crawling peg exchange rate arrangement was adopted with a view to stabilizing inflation expectations and to preventing the short-run speculative pressures that characterized the previous system of ad hoc exchange rate adjustments. Under the new arrangement, the forint is being depreciated by 1.9 percent per month during the second quarter; in the second half of the year, when inflation is expected to decelerate, the rate of crawl will be reduced to a maximum of 1.3 percent per month.

For the most part, Hungary's external trade and exchange system is free of restrictions. A new foreign exchange law and accompanying regulations have been submitted to Parliament and are intended to ensure that the new legislation will allow Hungary to adopt the obligations under Article VIII, Sections 2, 3, and 4 of the IMF's Articles of Agreement. Further trade liberalization measures were adopted at the beginning of 1995 in the context of agreements under the Uruguay Round and with the EU, EFTA, and CEFTA, and the few remaining restrictions are detailed in the Secretariat's background note.

The Government's March adjustment package presents a courageous first step towards securing macroeconomic stability. However, there are significant risks that the policy program on its own will not fully achieve the authorities' targets. The program relies heavily on wage restraint to effect a projected 15 percent improvement in competitiveness; but it remains uncertain if the implied large decline in real wages can be achieved. Moreover, even if wages could be restrained as envisaged, major effects on the external accounts are likely to arise only with some lag. From a saving-investment balance perspective, the fiscal adjustment may prove insufficient in 1995 with a budgeted improvement in the fiscal deficit (excluding privatization) of less than 1 percent of GDP, and a significant risk of slippages in some areas. In all, and taking into account first quarter developments, it is unlikely that the authorities' current account target for 1995 will be achieved, unless additional measures are taken. Moreover, even the envisaged current account target would not arrest the accumulation of external debt, as privatization is likely to be delayed and yield less than programmed. Under these circumstances, additional steps will have to be taken quickly--backed by structural measures, including pension reform, to increase domestic saving--to effect a more ambitious improvement in the external current account. The steps will need to include further fiscal consolidation, inter alia, to compensate for the phasing out of the import surcharge.